United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

ORIGINAL

76-7270

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Docket No. 76-7270

SOPHIE RUSKAY, LOUIS FELDMAN, Trustee etc., WEBSTER FACTORS, INC., and IRWIN L. FEINBERG, as Trustee etc.,

Plaintiffs-Appellants,

-versus-

CHAUNCEY L. WADDELL et al.,

Defendants-Appellees.

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On Appeal from the United States District Court for the Southern District of New York

PETITION FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

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Plaintiffs-appellants respectfully petition the Court pursuant to FRAP 40 for a rehearing of its decision of February 17, 1977. They also suggest, pursuant to FRAP 35, that a rehearing in banc is appropriate, because the proceeding involves a question of exceptional importance not heretofore determined by this Court:

Whether a judicially approved settlement of a stockholders' derivative action can validly authorize a general release of claims which have not been

pleaded in the complaint, have not been considered or scrutinized by the Court, and whose existence and proposed extinguishment have not been made known to the stockholders.

A majority of the Court's panel (Van Graafeiland and Meskill, JJ.) sustained the validity of the general release. Mansfield, J., dissented. We submit that the decision is contrary not only to FRCP 23.1 but to constitutional due process; its consequences for future settlements of derivative actions would be far-reaching and most unfortunate.

SUMMARY OF ARGUMENT

1. Before approving a derivative settlement, the Court must evaluate the strength of the claims to be discharged and balance them against the benefits of the settlement; City of Detroit v. Grinnell Corp., 495 F. 2d 448, 455 (2d Cir. 1974). But the Court cannot evaluate the unknown and unpleaded claims that are discharged by a general release. Such a release is, therefore, incompatible with the statutory functions of the Court under Rule 23.1; Girsh v. Jepson, 521 F. 2d 153, 159 (3d Cir. 1975).

2. The primary responsibility in negotiating a derivative settlement rests on the plaintiff who, under Rule 23.1, must "fairly and adequately represent the interests of the

shareholders." Adequate representation is required not only by the Rule, but by constitutional due process; Papilsky v. Berndt, 466 F. 2d 251, 259-60 (2d Cir.), cert. denied, 409 U.S. 1077 (1972). To be adequate, "the representation must be of such character as to insure the vigorous prosecution of the claim"; Papilsky, ibid. A derivative plaintiff cannot adequately represent the shareholders with respect to claims he has not pleaded, whether due to ignorance of their existence or lack of faith in their merit; he does not "insure the vigorous prosecution" of such claims. A general release of unpleaded claims as part of a derivative settlement is thus incompatible with the constitutional and statutory requirement of adequate representation.

3. A general release is also incompatible with the requirement of an adequate settlement notice to the stockholders. "Notice is essential in these situations [of voluntary dismissal or settlement] to ensure that the dismissal of the derivative suit is in the best interests of the corporation and the absent stockholders"; it enables the stockholders "to intervene to protect the corporate claim and to continue the litigation if that seems advisable", Papilsky, supra, 466 F. 2d at 258. A notice that unpleaded and unknown claims are to be extinguished by a general release leaves the stockholders in the dark and prevents them from protecting the corporate claims precisely because those

claims are unknown; the notice thus fails to fulfill its purpose. An inadequate notice is inconsistent with due process, Greenfield v. Villager Industries, 483 F. 2d 824, 833-34 (3d Cir. 1973), and deprives the judgment of res judicata effect, Smith v. Alleghany Corp., 394 F. 2d 381, 391 (2d Cir.), cert. denied, 393 U.S. 939 (1968).

4. If general releases are sanctioned by this Court, their use will become universal. Corporate wrongdoers will secure blanket absolution for undisclosed fiduciary breaches by paying a relative peppercorn for a general release. In the present case, the settlement of a $2,000,000 claim (A221; Diss. Op. 1839-40) for $650,000 has been held to wipe out a $62 million liability through the mechanics of a general release. Such a result may be tolerable in a release executed by a private party on his own behalf (as in the cases cited at Op. 1834); but in derivative or class settlements, in which the Court acts as the guardian of thousands of absent parties, a general release would be a serious injustice, would defeat due process and the purpose of Rule 23.1, and would be open to countless abuses.*

*Material factual errors of the Court's decision are referred to at pp. 9-10 , below.

SUMMARY OF RELEVANT FACTS

The plaintiffs in these four consolidated derivative actions are stockholders of defendant United Funds, Inc. ("United"), a registered mutual fund. They bring these actions against its directors, against Waddell & Reed, Inc. ("W&R"), United's investment adviser and principal underwriter, and against the principal stockholders of W&R. In 1969 the W&R stockholders, including three of the individual defendants, sold the stock of W&R to a new owner for $80 million, a price vastly in excess of W&R's asset value of $18 million. Under the Investment Company Act, 15 USC § 80a-15(a)(4) and 15(b)(2), the sale automatically terminated United's advisory and underwriting agreements with W&R (the "service agreements"). Since these agreements were the principal source of W&R's income, the parties to the sale conditioned their contract upon the reinstatement of the service agreements by the stockholders and directors of the Fund; the sellers and the management of the Fund agreed to and did procure their reinstatement (A7-8). Plaintiffs charge that the transaction constituted a sale of W&R's advisory and underwriting offices, and they seek to recover the $62 million excess of the sales price over the asset value of the stock under the principles of Rosenfeld v. Black, 445 F. 2d 1337 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972).

The District Court (Metzner, J.) summarily dismissed this claim (342 F. Supp. 264; A441) as barred by a judgment and

release issued in connection with the settlement of two earlier derivative actions brought by stockholders of United (the "Horenstein-Ruskay actions"). Commenced in 1967 and early 1969 (long before the W&R stock sale), these actions charged that a subsidiary of W&R, acting as stock broker for United, had engaged in improper brokerage practices yielding large illegal profits to W&R and its subsidiary at the expense of United (A84, 156). When the proposed sale of W&R's stock was announced in 1969, the Horenstein-Ruskay plaintiffs secured leave to and did file supplemental complaints alleging that part of the sales price was an outgrowth and, in effect, a capitalization of W&R's illegal brokerage profits and should, therefore, be impressed with a trust for the Fund (A107, 172). The Horenstein-Ruskay supplemental complaints did not, however, charge that the 1969 transaction was a sale of W&R's advisory and underwriting offices, nor did they allege the facts necessary to support such a charge.* Indeed, the Court below held that Horenstein-Ruskay "consciously avoided" such a claim (A447).

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*The Horenstein-Ruskay supplemental complaints (Op. 1837 n. 12; A107, 172) did not allege that the sales price for the W&R stock included a substantial premium in excess of the asset value of the stock; or that the sale terminated the service agreements; or that, in return for the premium, the sellers and W&R agreed to and did arrange for the reinstatement of the service agreements; or that the stockholders and directors of United did approve such reinstatement. These are essential elements of a claim under Rosenfeld (445 F. 2d at 1342, 1347 n. 13; see plaintiffs' appeal brief 22-26).

Ultimately the Horenstein-Ruskay actions were settled with court approval pursuant to FRCP 23.1. Neither the settlement notice to the stockholders of the Fund (A203) nor Judge Lasker's decision approving the settlement (A207) suggested that a claim for the sale of the advisory and underwriting offices was alleged or was to be included in the settlement. The judgment (A228) and the general release (A234) issued by United pursuant to this settlement were the basis on which the District Court dismissed the present actions (A441). This Court affirmed solely on the basis of the general release, but did not pass on the issue of res judicata (Op. 1839 and 1836 n. 11).

ARGUMENT

For present purposes we accept, arguendo, the Court's holding that the general release (Op. 1830-31; A234) was broad enough to include the present sale-of-office claim.* That claim, however, was not alleged in Horenstein-Ruskay; its existence was not revealed in the settlement notice to United's stockholders; Judge Lasker's settlement decision did not mention the claim, let alone scrutinize its possible merit. We submit that the discharge of the claim by a sweeping general release was invalid.

*For a contrary view of the scope of the release, see the dissenting opinion (1845-46) and plaintiffs' appeal brief (44-45).

1. The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because Judge Lasker's settlement decision gave no consideration to that claim.

When the Horenstein-Ruskay parties submitted their settlement to the Court, the plaintiffs advised Judge Lasker that their supplemental complaints - the only complaints referring to the W&R stock sale - had "become moot" and were "not a factor to be considered by the Court" (A388-89). Judge Lasker's settlement decision (A207) did, indeed, not so much as mention the stock sale, let alone consider a sale-of-office claim. In summarizing and carefully analyzing the plaintiffs' charges, he discussed solely the alleged brokerage abuses (A210-12, 214-20). Since the amount of the brokerage claim was about $2,000,000, Judge Lasker concluded that the settlement, ranging from $535,000 to $650,000, was "respectable" (A 221-22). It is hard to conceive that this decision could validly authorize the unwitting release of an unknown $62 million sale-of-office claim.

As noted, a court cannot approve a derivative settlement without scrutinizing the strength of the claims and balancing them against the benefits of the settlement, City of Detroit v. Grinnell Corp., supra, 495 F. 2d at 455; State of West Virginia v. Chas. Pfizer & Co., 440 F. 2d 1079, 1085 (2d Cir.), cert. denied sub nom. Cotler Drugs, Inc. v. Chas. Pfizer & Co., 404 U.S. 871 (1971). If an unpleaded claim is to be released, it

must be subjected to the same scrutiny and evaluation, Girsh v. Jepson, supra, 521 F. 2d at 159. The Horenstein-Ruskay settlement decision, far from evaluating the sale-of-office claim, did not even mention it.

This Court's present decision refused to consider the propriety of the general release because "one who has obtained the benefit of a settlement [should not be allowed] to object, in a subsequent proceeding, that the documents he helped draft were unfair to him" (Op. 1832 n. 4). This language referred to Sophie Ruskay, who is one of the plaintiffs here and was a plaintiff in Horenstein-Ruskay. The Court overlooked, however, that the three other plaintiffs in the case at bar - Louis Feldman, Webster Factors, Inc. and Irwin L. Feinberg - had nothing to do with the Horenstein-Ruskay litigation and certainly did not "help draft" the general release. The same error underlies the Court's remark about "plaintiff" having given a general release (Op. 1836); the three plaintiffs other than Sophie Ruskay did nothing of the sort. Plaintiffs' appeal brief (p. 38 n.) expressly referred to the difference between Ruskay and the three other present plaintiffs.*

*Equally erroneous is the Court's assumption that counsel for Horenstein-Ruskay were familiar with the sale-of-office theory because they were, at the same time, contesting the District Court decision in Rosenfeld v. Black (Op. 1836). The firm of Pomerantz Levy Haudek & Block, who prosecuted Rosenfeld v. Black and who are

(Footnote continued on following page)

2. The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because the plaintiffs could not adequately represent the stockholders with respect to that claim.

As noted, the requirement that a derivative plaintiff be an adequate representative of the stockholders is rooted not only in Rule 23.1 but in constitutional due process; Papilsky v. Berndt, supra, 466 F. 2d at 259-60. Adequate representation must be such "as to insure the vigorous prosecution of the claim", Papilsky, ibid. The Horenstein-Ruskay plaintiffs certainly did not vigorously prosecute the sale-of-office claim. They did not even plead the claim; their settlement brief expressly disavowed the supplemental complaints (A388-89), the only complaints mentioning the W&R stock sale. Since Horenstein-Ruskay thus did not adequately represent United's stockholders with respect to the sale-of-office claim, they were powerless to give the claim away by the device of a general release.

A settlement decree in a derivative suit is res judicata only "where the notice [to stockholders] and representation are adequate"; Smith v. Alleghany Corp., 394 F. 2d 381, 391 (2d Cir.), cert. denied sub nom. Smith v. Kirby, 393 U.S. 939 (1968);

(Footnote from previous page continued):

general counsel for the present plaintiffs, had nothing to do with the Horenstein-Ruskay litigation (plaintiffs' appeal brief, p. 16 n. 2; see list of Horenstein-Ruskay counsel, A203, 207).

7A C. Wright and A. Miller, Fed. Prac. & Proced., Civil (1972), § 1840, p. 440. Since an inadequate representative cannot bind his fellow stockholders by res judicata, he cannot escape the constitutional requirement of adequate representation by adding a release to his settlement.

3. The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because the settlement notice did not advise the stockholders that such a claim was to be released.

The Horenstein-Ruskay settlement notice described the proposed release as discharging defendants from liability with reference to any "matters or transactions described or referred to in the various pleadings by the plaintiffs" (A206). The scope of the release was thus to be determined by the contents of the plaintiffs' pleadings. In describing those pleadings, the notice set forth the alleged brokerage abuses in considerable detail (A203-204); but the supplemental complaints were simply described as alleging -

> "that the defendants Waddell, Merriman and Roach arranged to sell a majority of the voting shares of W&R held by themselves and members of their families at a price of $80 per share; that such price was largely attributable to the profits derived by W&R from the acts, transactions and practices complained of in their principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of United." (A205)

This was followed by a summary of the defenses to the supplemental

complaints (A205).*

The notice thus did not reveal that the stock sale would transfer control of W&R; it was said to involve only a majority of the voting shares held by the named individuals and their families. Nor did the notice reveal that the total sales price was $80 million; or that it substantially exceeded the asset value of the stock; or that the sale would terminate the service agreements; or that the sellers and W&R were to be paid for arranging the reinstatement of the service agreements; or that the agreements were, in fact, reinstated.

By no stretch of imagination could a reader of this notice have guessed that the settlement and release were to include a $62 million sale-of-office claim, i.e., a claim that the defendants, for private gain, had used their fiduciary influence with the stockholders and directors of United for the reinstatement of the service agreements. Stockholders, reading the notice, had no reason to suspect that such a claim, unrevealed by the notice and far exceeding in importance the claims disclosed, was to fall by the wayside. A settlement notice is designed to inform the stockholders, not to become a trap for the unwary. The Horenstein-Ruskay notice was inadequate to warn

*Since the scope of the release was to be determined by the contents of the plaintiffs' pleadings, the recital of the defenses in the notice is, for present purposes, not relevant.

the stockholders of the effects of the proposed general release.

As noted, an adequate settlement notice is required not only by Rule 23.1 but by due process, Greenfield v. Villager Industries, supra, 483 F. 2d at 833-34; Grunin v. International House of Pancakes, 513 F. 2d 114, 120 (8th Cir.), cert. denied, 423 U.S. 864 (1975); Milstein v. Werner, 57 F.R.D. 515, 518 (S.D.N.Y. 1972); see Eisen v. Carlisle & Jacquelin, 391 F. 2d 555, 564-65 (2d Cir. 1968). Just as a settlement decree based on an inadequate notice is not res judicata, Smith v. Alleghany Corp., supra, 394 F. 2d at 391, it cannot validly authorize a general release.

It is no answer, as suggested by the Court (Op. 1832 n. 4), that any objection to the grant of a general release should have been made in the settlement hearing before Judge Lasker. The stockholders of United could not object, precisely because the settlement notice did not give them the necessary information. In any event, the infirmity of the general release is of constitutional dimensions, because of the inadequacy of both the representation and the notice. The ineffectiveness of such a release - just as the ineffectiveness of an unconstitutional settlement decree as res judicata - can be raised collaterally and does not depend on the happenstance of stockholders' objections.

CONCLUSION

For the foregoing reasons, as well as those set forth in Judge Mansfield's dissenting opinion, the petition for rehearing and the suggestion of rehearing in banc should be granted.

Dated: March 3, 1977.

Respectfully submitted,

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STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

PEARL R. FRUHLING, being duly sworn, deposes and says, that on March 3, 1977, she served the within petition for rehearing and suggestion for rehearing in banc upon the attorneys for the parties listed below in the within action, by enclosing two true copies thereof to each in securely sealed postpaid wrappers addressed, respectively, as follows:

COLE & DEITZ, ESQS.
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and by depositing the same in the post office box regularly maintained by the United States Government at 295 Madison Avenue, New York, N.Y.

Deponent further says that the above listed are the attorneys for the parties listed above and that the addresses set forth on said wrappers are the office and post office addresses given in the within action.

Pearl R. Fruhling
Pearl R. Fruhling

Sworn to before me this
3rd day of March, 1977

NOTARY PUBLIC, STATE OF NEW YORK
No. 31-[illegible]
Qualified in New York County
Commission Expires March 30, 1978